In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 530

GARDENS OF FAITH, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

RAYMOND F. CUSHING AND KATHRYNE R. CUSHING, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 5A–52A)[1] are not officially reported. The *per curiam* opinion of the court of appeals (Pet. 1A–2A) is reported at 345 F. 2d 180.

[1] "R." references are to petitioner's printed appendix in the court of appeals.

789-010—65

JURISDICTION

The judgments of the court of appeals were entered on March 18, 1965 (Pet. 3A, 4A). A petition for rehearing was denied on June 7, 1965 (Pet. 5A). The petition for a writ of certiorari was filed on September 3, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below erred in holding that payments made by a for-profit cemetery corporation to its "certificate of indebtedness" holders actually constituted equity distributions, and thus (a) were not deductible by the corporation and (b) constituted ordinary income (i.e., dividends) to the payees.

STATEMENT

Petitioner Raymond F. Cushing (Cushing) had been in the cemetery business for many years. In 1956 he entered into an agreement to purchase undeveloped cemetery land for approximately $172,500. Cushing needed additional money to make this purchase but had difficulty obtaining it because he insisted on having the controlling interest in the corporation to be formed. After extensive negotiations he worked out a deal with two investors, Murray and Mettee, and the following transactions took place:

Murray and Mettee borrowed $200,000 from a bank; Cushing guaranteed the loan. Most of this money was used to purchase the cemetery land in the name of a nominee. The parties formed petitioner Gardens of Faith, Inc. (Gardens) to run the cemetery. In a

complicated series of transactions set forth in great detail in the Tax Court's opinion, (1) Cushing acquired all of Gardens' stock and half of its "certificates of indebtedness" and Murray and Mettee acquired the other half of its "certificates of indebtedness," (2) Gardens received the cemetery land from the nominee title holder, (3) Murray and Mettee remained liable to the bank for the cost of the land (with Cushing contingently liable), (4) Cushing paid Gardens $25,000 for "certificates" and $1,000 for stock and agreed to pay it an additional $12,550 for stock in the future, and (4) Cushing agreed to pay Murray and Mettee $75,000.

The "certificates of indebtedness" entitled Murray, Mettee and Cushing to receive 25% of the gross sales price (less certain expenses) of all cemetery lots sold for 50 years. The Tax Court found that all the lots would probably be sold during that period. Any profits remaining after the payment of this 25% of gross sales proceeds would, of course, inure to Cushing as owner of all the capital stock. Murray and Mettee were given the right to elect one of the three directors, and if during any of the first 9 years of operation less than $500,000 of lots were sold, they were entitled to appoint a sales manager for Gardens.

During Gardens' first three years in business it paid out more than $350,000 on the "certificates of indebtedness." It deducted these payments on its income tax returns as a cost of the lots which it had sold. If these payments are deductible, Gardens' total taxable income for these three years would be less than

$19,000. Gardens paid no "dividends" during this period.

The Commissioner contended that the "certificates of indebtedness" were actually equity interests in the corporation and that the $350,000 of payments thereon were non-deductible dividends. According to this view, the parties exchanged the land for an equity interest in a controlled corporation; Gardens' basis in the land would thus be the amount that Murray and Mettee paid for it. 1954 Code § 362(a). Moreover, the Commissioner treated the payments to the holders of the "certificates of indebtedness" as dividends to the extent of Gardens' earnings and profits, rather than as nontaxable return of capital and thereafter capital gain as the individual petitioners had reported them. The Tax Court concluded that the Commissioner's determinations were correct, and the court of appeals affirmed *per curiam*. (R. 7A–9A, 17A–33A, 45A; Pet. 1A–2A.)

ARGUMENT

The case presents a mixed question of law and fact. The lower courts applied the correct legal principles and the Tax Court's resolution of the factual issues was warranted.

1. This Court has ruled that whether a purported debt instrument is in reality an equity investment is essentially a question of fact, and that "There is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments

in the corporations or debts." *John Kelley Co.* v. *Commissioner*, 326 U.S. 521, 526–527, 530. "It is often said that the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event." *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182, 186 (C.A. 7). See also, *Jewell Ridge Coal Corp.* v. *Commissioner*, 318 F. 2d 695, 698 (C.A. 4). The taxpayer has the burden of proving that the instrument in issue represents debt rather than an equity interest. *John Kelley Co.* v. *Commissioner, supra; Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159, 166 (C.A. 6), certiorari denied, 352 U.S. 1031.

The record fully warrants the Tax Court's conclusion that the so-called "certificates of indebtedness" in reality constituted equity interests. Murray and Mettee supplied most of the money necessary for the venture and Cushing supplied know-how and services. The parties desired to split the profits of the corporation, with approximately half going to Murray and Mettee and half to Cushing. These, of course, are the classic desires of stockholders. Cushing's refusal to give up control did not prevent all the parties from receiving stock to evidence their interests. Cushing could have received 51% of the stock, or two classes of stock could have been issued with Cushing's class entitled to elect two of the 3 directors. Instead, the parties devised a method for splitting the profits that had manifest tax avoidance aspects.

The parties formed a corporation with a nominal amount of paid in capital—*i.e.*, $1,000 (later increased to $13,550)—and "sold" the land to it in exchange for "certificates of indebtedness" which "obligated" Gardens to pay them 25% of its gross proceeds from sales of lots. By this device virtually all of the profits of the corporation were siphoned off, leaving a minimal corporate net income. (During the first three years more than $350,000 was paid on the "certificates" while the corporation had less than $19,000 of "profits" after these payments.)

By using a percentage of gross sales as the measure of the corporation's "debt," the withdrawals during the first 3 years alone were nearly double the land's original cost. And far more substantial proceeds were expected in later years.

The "certificates of indebtedness" have all the attributes of an equity interest. There is no maturity date, no fixed amount of principal, and no stated interest. Instead the certificate holders are entitled to a wholly contingent share of the corporation's sales proceeds, and the certificates' value is completely contingent on the corporation's success. Moreover, while Murray and Mettee supplied the vast majority of the money, Cushing received exactly half of the certificates.[2] The parties themselves obviously regarded the payments on the certificates as a means of distributing the lion's share of the venture's profits.

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[2] Additionally, Murray and Mettee, who held only "certificates", were given the right to elect a director and in certain circumstances to appoint Gardens' sales manager.

Petitioners argue that to tax Gardens on the amount paid out on the "certificates" would constitute a tax on gross income. But it is quite clear that a corporation cannot transform dividends into deductible expenses merely by obligating itself in writing to make the payments. If Gardens lacks funds to pay the corporate tax on the $350,000 already paid out, it is only because these funds have been withdrawn from the corporation by its stockholders.[3]

2. The decision below is in accord with four other recent decisions. *Sherwood Memorial Gardens, Inc. (Tennessee)* v. *Commissioner,* decided by C.A. 7 on July 1, 1965 (65–2 U.S.T.C., par. 9537); *Peterson* v. *Commissioner,* decided June 1, 1965 (P–H Memo T.C., par. 65,151); *Peterson* v. *Commissioner,* decided April 21, 1965 (P–H Memo T.C., par. 65,108); on appeal to C.A. 9; *Roe* v. *Commissioner,* decided April 15, 1965 (P–H Memo T.C., par. 65,100). In those cases certificates of indebtedness substantially similar to those in issue in the instant case were also held to constitute an equity investment.

Petitioners' contention (Pet. 13) that the decision below conflicts with *Commissioner* v. *Kensico Cemetery,* 96 F. 2d 594 (C.A. 2), is unfounded. The court's focus in that case was on a different question,

[3] Whether the individuals are liable for the corporation's taxes as transferees (see 1954 Code § 6901; *Commissioner* v. *Stern,* 357 U.S. 39; *Rubel* v. *Commissioner,* 74 F. 2d 27 (C.A. 6)), the corporation's assets are undoubtedly sufficient to pay at least part of the tax liability, and the court of appeals' decision will prevent them from withdrawing additional earnings tax-free in the future.

whether Kensico was entitled to tax exemption as a non-profit enterprise. Moreover, the Second Circuit in *Kensico* expressly relied on the fact that the cemetery corporation there in question was prohibited by State law from issuing stock. Regardless of the validity of this distinction, it is by no means certain that the Second Circuit would decide the instant case—involving a for-profit corporation with capital stock—the same way. See *Sherwood Memorial Gardens (Tennessee)* v. *Commissioner,* 42 T.C. 211, 231, affirmed by C.A. 7 (65–2 U.S.T.C., par. 9537).

3. Petitioners claim that the decision below conflicts with *Commissioner* v. *Brown,* 380 U.S. 563, where this Court concluded that the stockholders of Clay Brown and Company were entitled to capital gain treatment on the sale of their stock to an exempt organization. The instant case differs from *Brown* in several important respects. In *Brown,* the sellers entered into an arms length sale of stock under which they were to receive a fixed dollar amount which the lower courts had found to be a reasonable price for the asset sold. Here, however, the sale of the land to Gardens was clearly not at arms length; Murray, Mettee and Cushing, who owned all of Gardens' equity interest, were to receive no fixed amount, but an open-ended 25% of the corporation's proceeds from sales for 50 years. There is no evidence that Gardens would have entered into such a transaction with outsiders on such terms.

CONCLUSION

The issue presented is primarily one of fact which was correctly resolved by the lower courts. There is no conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

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